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EXPOSURE DRAFT

PROPOSED STATEMENT ON AUDITING STANDARDS

TIMING OF SUBSTANTIVE TESTS

OCTOBER 1, 1982

**Prepared by the AICPA Auditing Standards Board
For comment from persons interested in auditing and reporting**

**Comments should be received by December 30, 1982, and addressed to
AICPA Auditing Standards Division, File 4450
AICPA, 1211 Avenue of the Americas, New York, N.Y. 10036-8775**

SUMMARY

Auditors often perform procedures such as observation of the taking of physical inventories or confirmation of accounts receivable as of a date that is before the balance-sheet date. This proposed Statement provides guidance on the factors auditors should consider before applying such substantive tests at interim dates. It indicates that auditors should consider

- Whether adverse business conditions or the inability of the accounting system to process information accurately increases the risk of applying tests of details at interim dates.
- Whether the effectiveness of substantive tests might be impaired by the absence of particular internal accounting control procedures.
- Whether sufficient evidential matter will be available at both the interim date and the balance-sheet date and concerning the transactions that occur between those dates.
- Whether audit conclusions drawn from the interim work might not remain valid at the balance-sheet date.

This proposed Statement also provides guidance on auditing procedures that should be applied to provide a reasonable basis for extending the audit conclusions at the interim date to the balance-sheet date.

This exposure draft has been sent to

- *practice offices of CPA firms*
 - *members of AICPA Council and technical committee chairmen*
 - *state society and chapter presidents, directors, and committee chairmen*
 - *organizations concerned with regulatory, supervisory, or other public disclosure of financial activities*
 - *persons who have requested copies*
-



American Institute of Certified Public Accountants

1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

October 1, 1982

Accompanying this letter is an exposure draft of a proposed Statement on Auditing Standards entitled Timing of Substantive Tests. The proposed SAS would supersede SAS No. 1, section 310.05 through 310.09. A summary of the proposed SAS accompanies this letter.

Comments or suggestions on any aspect of this exposure draft will be appreciated. The AICPA Auditing Standards Board's consideration of responses will be helped if the comments refer to the specific paragraph numbers and include supporting reasons for any suggestions or comments.

In developing guidance, the AICPA Auditing Standards Board considers the relationship between the cost imposed and the benefits reasonably expected to be derived from audits. It also considers differences that the auditor may encounter in the audit of the financial statements of small businesses and, when appropriate, makes special provisions to meet those needs. Thus, the board would particularly appreciate comments on those matters.

Responses should be sent to the AICPA Auditing Standards Division, File 4450, in time to be received by December 30, 1982. For your convenience, a post-paid mailer is attached to this exposure draft. Written comments on the exposure draft will become part of the public record of the AICPA Auditing Standards Division and will be available for public inspection at the offices of the American Institute of Certified Public Accountants after January 17, 1983, for one year.

Sincerely,

A handwritten signature in cursive script that reads "James J. Leisenring".

James J. Leisenring
Chairman
Auditing Standards Board

A handwritten signature in cursive script that reads "D. R. Carmichael".

D. R. Carmichael
Vice President, Auditing

PROPOSED STATEMENT ON AUDITING STANDARDS

TIMING OF SUBSTANTIVE TESTS

(Supersedes Statement on Auditing Standards No. 1, section 310.05 through 310.09)¹

1. This Statement provides guidance for audits of financial statements, concerning —

- a. Factors to be considered before applying substantive tests to the details of particular balance-sheet accounts prior to the balance-sheet date.
- b. Auditing procedures to provide a reasonable basis for extending to the balance-sheet date the audit conclusions from such tests of details.
- c. Substantive tests that can be applied, apart from the considerations in (a), above, to transactions through any selected date prior to the balance-sheet date.
- d. Coordinating the timing of auditing procedures.

This Statement is not applicable when the date of the balance of an asset or liability account as of which the principal substantive tests will be applied to the details of the balance is subsequent to the balance-sheet date.

2. The following definitions apply in this Statement:

Balance-sheet date. Date of the balance sheet on which the auditor is reporting.

Interim date. Date, prior to the balance-sheet date, of a specific asset or liability account balance as of which the principal substantive tests will be applied to the details of the balance.

Remaining period. Period from an interim date to the balance-sheet date.

¹This Statement also amends SAS No. 1, section 310, by deleting the last two sentences of section 310.03 and replacing section 310.02 with the following:

Aspects of supervising assistants are discussed in section 210, "Training and Proficiency of the Independent Auditor" and SAS No. 22, *Planning and Supervision*. Aspects of planning field work and the timing of auditing procedures are discussed in SAS No. 22 and SAS No. XX, *Timing of Substantive Tests*. This section describes the relationship between the auditor's appointment and planning.

3. Audit testing at interim dates may permit early consideration of significant matters affecting the year-end financial statements (for example, related-party transactions, changed conditions, and financial statement items likely to require adjustment). Much of the audit planning, the study and evaluation of internal accounting control, and the application of substantive tests to transactions can be conducted prior to the balance-sheet date. However, the ultimate risk² associated with the examination of a balance-sheet account is potentially increased whenever the principal substantive tests are applied to the details of the balance as of an interim date rather than as of the balance-sheet date. The potential for an increase in the ultimate risk tends to become greater as the remaining period is lengthened. This potential can be controlled, however, if substantive tests covering the remaining period can be designed that will provide a reasonable basis for extending to the balance-sheet date the audit conclusions from such tests of details at the interim date.

FACTORS TO BE CONSIDERED BEFORE APPLYING SUBSTANTIVE TESTS TO THE DETAILS OF BALANCE-SHEET ACCOUNTS AT INTERIM DATES

4. Before applying substantive tests to the details of asset or liability accounts at an interim date, the auditor should assess the incremental difficulty in controlling ultimate risk. In making that assessment, the auditor should consider —

- a. Whether adverse conditions or factors are present that add to the difficulty in controlling ultimate risk (paragraph 5).
- b. Whether the effectiveness of certain substantive tests covering the

remaining period might be impaired by the absence of particular internal accounting control procedures (paragraph 6).

- c. Whether sufficient evidential matter will be available at both the interim date and the balance-sheet date and concerning the transactions that occur between those dates (paragraph 7).
- d. Whether audit conclusions drawn from the interim work might not remain valid at the balance-sheet date (paragraph 8).

In addition, the auditor should consider the cost of the substantive tests covering the remaining period that are necessary to provide the appropriate audit assurance at the balance-sheet date. Applying substantive tests to the details of asset and liability accounts at an interim date may not be cost-effective if the required substantive tests covering the remaining period cannot be restricted in reliance on the system of internal accounting control.

5. The auditor should consider whether the accounting system is characterized by inaccuracy or delay in recording transactions, omission of essential information, inadequate review of accounting estimates, or failure to maintain details of account balances and reconcile such details with control accounts promptly. The auditor should also consider whether there are other adverse factors that (a) increase the level of risk ordinarily attributable to the inherent limitations of internal accounting control, (b) might predispose management to misstate financial statements³, or (c) arise from the general business environment. If such adverse conditions or factors are present, the auditor might conclude that substantive tests covering the remaining period would not be effective in controlling the in-

²The term *ultimate risk* is defined in paragraph 8 of SAS No. 39, *Audit Sampling*.

³See paragraph 11 of SAS No. 6, *Related Party Transactions*, and paragraphs 9 and 10 of SAS No. 16, *The Independent Auditor's Responsibility for the Detection of Errors or Irregularities*.

cremental risk associated with them. In these circumstances, the asset and liability accounts affected should ordinarily be examined as of the balance-sheet date.

6. A soundly conceived and carefully maintained accounting system that is complemented by appropriate internal accounting control procedures is generally conducive to applying effective substantive tests covering the remaining period. The suitability of accounting records for designing substantive tests to provide a reasonable basis for extending the audit conclusions from an interim date to the balance-sheet date, however, is not necessarily dependent on the system of internal accounting control. But the effectiveness of certain of such substantive tests may be impaired if particular internal accounting controls are not present. For example, if suitable controls are lacking over the independent internal sources of information that provide indications of transactions that have been executed, the effectiveness of substantive tests covering the remaining period that are related to the completeness of the recording of transactions in the asset and liability accounts that are affected may be impaired if based on such information. In those cases, additional sources of audit assurance should be sought or the accounts should ordinarily be examined as of the balance-sheet date. Likewise, the absence of suitable controls over the physical movement of assets may impair the effectiveness of substantive tests covering the remaining period that are related to the existence of the assets at the balance-sheet date. In those cases, substantive tests relating to the existence of assets represented by the particular affected accounts should ordinarily be performed as of the balance-sheet date.

7. In determining whether particular asset and liability accounts may be susceptible of examination at interim dates, the auditor should consider the evidential matter that will be available concerning the

details of the items composing the account balances. The auditor should also consider the entity's proposed procedures for analyzing and adjusting such accounts, and for establishing proper accounting cutoffs. If the auditor concludes that sufficient evidential matter concerning the details of a particular asset or liability account at an interim date will not be available and the entity is unable or unwilling to prepare it, the account should be examined as of the balance-sheet date. In addition, the auditor should consider whether the accounting system will provide appropriate information at an adequate level of detail concerning the balances at the balance-sheet date and the transactions in the remaining period. The level of detail should be sufficient to permit investigation of (a) significant unusual transactions or entries (including those at or near year end), (b) changes in the composition of account balances due to the inclusion of large items not tested at the interim date, and (c) other causes of significant fluctuations, or expected fluctuations that did not occur.

8. Asset and liability accounts with balances that are reasonably predictable as to composition and amount at particular times are better suited to examination at interim dates than account balances that fluctuate unpredictably. The auditor should consider (a) whether rapidly changing business conditions are present that could substantially alter the relative significance or composition of the accounts at the balance-sheet date from that at the interim date, or that could introduce other factors not present at the interim date and (b) whether an account is likely to be affected by transactions in the remaining period that will significantly affect the interim conclusions or that will require the reperformance of certain auditing procedures. If audit conclusions drawn from the interim work might not remain valid at the balance-sheet date, the asset or liability accounts affected should ordinarily be examined as of the balance-sheet date.

EXTENDING AUDIT CONCLUSIONS TO THE BALANCE-SHEET DATE

9. The substantive tests covering the remaining period should be so designed that the assurance from such tests and the substantive tests applied to the details of the balance as of an interim date achieve the audit objectives at the balance-sheet date.⁴ Such tests ordinarily should include (a) comparison of information at an appropriate level of detail concerning the balance at the balance-sheet date with the comparable information at the interim date to identify items that appear unusual in nature or amount and investigation of any such items and (b) other analytical review procedures or substantive tests of details, or a combination of both, to provide a reasonable basis for extending to the balance-sheet date the audit conclusions relative to the assertions tested directly or indirectly at the interim date.

10. The auditor should consider whether the results of the audit work at interim dates indicate a need to modify the audit plan and whether there are matters that require specific follow-up in connection with the year-end audit work. The detection of monetary errors in account balances at an interim date may require modification of the nature, timing, or extent of the substantive tests covering the remaining period that relate to such accounts or reperformance of certain auditing procedures at the balance-sheet date. The estimate of errors as of the balance-sheet date should be based on the auditor's judgment of the state of the particular account(s) as of that date, after considering (a) the possible implications of the nature and cause of the errors detected at the interim date, (b) the possible relationship to other phases

⁴If the substantive tests are to be restricted in reliance on the system of internal accounting control, see SAS No. 1, section 320.65 (as amended by SAS No. 43, *Omnibus Statement on Auditing Standards*), for factors to be considered in deciding whether compliance tests should be applied throughout the remaining period.

of the audit, (c) the corrections subsequently recorded by the entity, and (d) the results of auditing procedures covering the remaining period (including those that are responsive to the particular possibilities for error). For example, the auditor might conclude that the estimate of unrecorded credit memos at an interim date is representative of such errors at the balance-sheet date, based on substantive tests covering the remaining period. On the other hand, the estimate of the effects at the balance-sheet date of other types of cutoff errors at an interim date might be based on the results of reperforming substantive tests of the cutoff.

**SUBSTANTIVE TESTS THAT CAN BE
APPLIED TO TRANSACTIONS
THROUGH ANY SELECTED DATE**

11. No matter what date is selected for applying substantive tests to the details of asset and liability

accounts, there are substantive tests that can be applied to transactions through any selected date prior to the balance-sheet date and completed as part of the auditor's year-end procedures. Such substantive tests include (a) tests of details of the additions to and reductions of accounts such as property, investments, and debt and equity capital, (b) tests of details of transactions affecting income and expense accounts and other accounts that are not to be audited by testing the details of items composing the balance, and (c) analytical review procedures applied to income and expense accounts. In addition, there are preliminary inquiries and arrangements that the auditor can make to facilitate the year-end work.

**COORDINATING THE TIMING OF
AUDITING PROCEDURES**

12. The timing of auditing procedures also involves consideration of

whether related auditing procedures are properly coordinated. This includes, for example —

- a. Coordinating the auditing procedures applied to related-party transactions and balances.⁵
- b. Coordinating the testing of inter-related accounts and accounting cutoffs.
- c. Maintaining audit control over assets that are readily negotiable and simultaneously examining such assets and cash on hand and in banks, bank loans, and other related items.

Decisions about coordinating related auditing procedures should be made in the light of the effectiveness of internal accounting control in a particular situation and of the particular auditing procedures that could be applied, either for the remaining period or at year end or both.

⁵See SAS No. 6, *Related Party Transactions*.